

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
ESTATE OF JOHN M. HISS, SR., }
DECEASED, AND ELLA N. HISS)

Appearances:

For Appellants: W. H. Jeffrey
Certified Public Accountant

For Respondent: Paul J. Petrozzi
C o u n s e l ,

OPINION

This appeal is made pursuant to section 18594 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of the Estate of John M. Hiss, Sr. , Deceased, and Ella N. Hiss against proposed assessments of additional personal income tax in the amounts of \$1,025.41, \$1,296.24, and \$4,971.15 for the years 1964, 1966, and 1967, respectively.

The decedent, Dr. John M. Hiss, Sr. , who was a medical doctor by profession, will be referred to as appellant for convenience.

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In addition to the practice of his profession, appellant was engaged in several business ventures. In connection with his medical practice, he developed certain specially designed footwear and obtained a patent thereon. The shoes were manufactured in Ohio by an Ohio corporation under appellant's patent, and marketed by a second Ohio corporation. Appellant owned no interest in the manufacturing corporation and only two percent of the stock of the marketing corporation.

Appellant marketed the shoes through five retail outlets located throughout Southern California. All of appellant's business interests were held by Dr. Hiss Realty, Inc., a California corporation of which appellant owned 100 percent of the outstanding stock. During 1960 appellant sold all the stock in Dr. Hiss Realty, Inc., to a corporate purchaser. The buyer did not wish to operate the shoe stores so a separate corporation, Dr. Hiss Shoe Stores, Inc., was formed for this purpose. Soon after the corporation began operating the shoe stores, it became obvious that the operation was unprofitable. In 1961, for reasons that do not appear in the record, appellant reacquired Dr. Hiss Shoe Stores, Inc., by purchasing all 50 shares of its outstanding stock for a total consideration of \$2,500.00. After the reacquisition, appellant hired a manager to continue operating the shoe stores.

The stores continued to be unprofitable. Therefore, shortly after the reacquisition, appellant alleges that he began to advance funds to the corporation to cover operating losses. Appellant contends that he received notes from the corporation in return for his advances; however, no notes receivable or other indicia of indebtedness were ever offered in evidence. Although the stores remained unprofitable, appellant maintains that until 1964 there was a reasonable prospect of profitable operations. However, as a result of a loss exceeding \$32,000.00 which was incurred during that year, it was realized that the stores would never operate economically. Nevertheless, with an inventory in shoes and accessories exceeding \$148,000.00, appellant decided to continue operations in order to increase the amount realized from the inventory, rather than to take a greater loss through a forced sale. This process, characterized as a "liquidation" by appellant, has continued for ten years, during which time the stores purchased over \$250,000.00 worth of inventory. At least

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one store was still in operation at the time this matter was heard.

According to appellant, during 1964 it became obvious that the losses incurred up to that time would never be recovered. Therefore, appellant concluded that his stock in the shoe stores and alleged notes receivable in an amount equivalent to the stores' actual cash loss for that year were entirely worthless. Accordingly, in his 1964 California personal income tax return, under the heading "Bad Debt Losses (Completely Worthless)", appellant claimed the following short term capital losses:

Dr. Hiss Shoe Stores, Inc. (Stock)	\$ 2,500.00
Dr. Miss Shoe Stores, Inc. (Notes receivable)	30,213.78

The shoe stores continued to lose money. By 1966, since no buyer could be found, it became necessary to abandon the two stores located in Pasadena and San Diego, in order to reduce further losses and to continue the orderly liquidation of the inventory. According to his previous practice, appellant determined that additional alleged notes receivable from the stores were uncollectible and claimed a \$30,035.36 nonbusiness bad debt as a short term capital loss for 1966.

In 1967 the shoe stores suffered another large loss. Following his past practice appellant wrote off \$99,421.91 in alleged notes receivable, and claimed that amount as a nonbusiness bad debt.

Respondent determined that there was no basis for the claim that either the stock or the notes receivable became worthless in the years for which the deductions were claimed. Accordingly, respondent disallowed the deductions and proposed the additional assessments which form the basis for this appeal.

The sole issue for determination is whether the deductions claimed for the worthless stock and the bad debts were properly disallowed.

Section 17207 of the Revenue and Taxation Code provides for the deduction of "any debt which becomes worthless within the taxable year." Initially, the taxpayer must establish the existence of a bona fide debt. (Matthiessen v. Commissioner, 194 F.2d 659.) A bona fide debt arises from a debtor -creditor relationship based upon a valid and enforceable obligation to pay a sum certain in money.

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A contribution to capital does not constitute a debt. (Cal. Admin. Code, tit. 15, reg. 17207(a), subd. (3).) Whether advances by a taxpayer to a corporation are loans or capital contributions is a question of fact. (Gilbert v. Commissioner, 262 F. 2d 512, cert. denied, 359 U.S. 1002 [3 L. Ed. 2d 1030].)

In each of the three years in issue appellant deducted large sums as bad debts resulting from alleged notes receivable becoming worthless during those years. However, appellant has offered minimal evidence tending to establish the existence of any such indebtedness. No contracts, notes receivable, or other indicia of indebtedness were ever offered for consideration. The only evidence offered by appellant was the minutes of a special meeting of the directors of the corporation held on October 31, 1966. The minutes merely indicated that the sum which appellant deducted as a bad debt for that year was to be written off by appellant as "uncollectible and worthless."

While there is no single test which is controlling, the most important principle in determining whether advances by a shareholder to a closely held corporation are debts or capital contributions is that no valid debt exists unless there is an unconditional obligation to pay the taxpayer a definite sum of money. (United States v. Henderson, 375 F. 2d 36.) Thus, appellant's failure to submit any convincing evidence tending to establish the existence of such an obligation is fatal to his position. That the advances continued, in view of the increasing corporate losses, further emphasizes the fact that a prudent creditor would not continue to make such unsecured loans with any expectation of repayment. The inescapable conclusion is that appellant's advances were contributions to capital made to extend the corporation's existence and, hopefully, reduce appellant's ultimate loss. (Dodd v. Commissioner, 298 F.2d 570; see also American - La France - Foamite Corp. v. Commissioner, 284 F. 2d 723.)

Since we have characterized appellant's advances to the shoe stores as contributions to capital rather than loans, the resulting losses, if any, could not be bad debt losses. The advances served to increase appellant's basis in the stock of the corporation and would be deductible, if at all, as a loss from worthless securities. (See Appeal of George E. , Jr. , and Alice J. Atkinson,

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Cal. St. Rd. of Equal. , Feb. 18, 1970; Appeal of Milton W. Vedder,
Cal. St. Bd. of Equal. , Sept. 23, 1943.)

Section 17206 of the Revenue and Taxation Code provides for the deduction of the loss from any security which becomes wholly worthless during the taxable year. In order to qualify for the deduction, the loss must be evidenced by closed and completed transactions, fixed by identifiable events, and actually sustained during the taxable year. (Cal. Admin. Code, tit. 18, reg. 17206(a), subd.(2).) The burden is upon the taxpayer to establish that the securities became totally worthless in the year for which the deduction is claimed. (Mahler v. Commissioner, 119 F.2d 869, cert. denied, 314 U. S. 660 [86 L. Ed. 529]; Appeal of William C. and Lois B. Hayward, Cal. St. Bd. of Equal. , Oct. 3, 1967.) In the instant matter appellant has failed to establish that the securities in Dr. Hiss Shoe Stores, Inc. , became worthless in any particular year or that they became worthless at all during the years in issue.

Appellant has emphasized the fact that the corporation has been in serious financial condition and has been involved in a ten-year process characterized as a "liquidation. " However, even if we agree with appellant's characterization, the mere fact of a liquidation is not sufficient to establish the worthlessness of the corporate securities. (Appeal of Milton W. Vedder , supra.) Nor is it sufficient that the corporation's liabilities exceed its assets (Appeal of Carson B. and Bessie H. Hubbard, Cal. St. Bd. of Equal., Oct. 26, 1944); or that the stock has suffered some diminution in value. (875 Park Avenue Co. v. Commissioner, 217 F.2d 699.) However, in the instant matter the most important factor is that the corporation has continued in business, a fact which standing alone refutes the assertion that the securities became totally worthless during any of the years in issue. (Appeal of William C. and Lois B. Hayward, supra.) Thus, we must conclude that appellant has failed to establish that the securities became totally worthless in any of the years for which deductions were claimed.

Accordingly, we conclude that respondent's action in disallowing the deductions claimed for the worthless stock and the bad debts was proper and must be sustained.

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O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of the Estate of John M. Hiss, Sr., Deceased, and Ella N. Hiss against proposed assessments of additional personal income tax in the amounts of \$1,025.41, \$1,296.24, and \$4,971.15 for the years 1964, 1966, and 1967, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 23rd day of September, 1974, by the State Board of Equalization.

_____, Chairman

_____, Member

_____, Member

_____, Member
_____, Member

ATTEST:
_____, Secretary